DEPARTMENT OF STATE REVENUE

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Letter of Findings: 09-0653
Sales and Use Tax
For the Years 2006 and 2007

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ISSUES

I. Sales and Use Tax – Exemptions.

Authority: IC § 6-2.5-1-1 et seq.; IC § 6-2.5-3-4; IC § 6-2.5-5-3; IC § 6-2.5-5-5.1; IC § 6-8.1-5-1; 45 IAC 2.2-3-12; 45 IAC 2.2-5-8; Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Indiana Dep't of State Revenue v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974); Hartranft v. Wiegmann, 121 U.S. 609 (1887); Anheuser-Busch Brewing Ass'n v. United States, 207 U.S. 556 (1908); Indiana Creosoting Co. v. McNutt, 5 N.E.2d 310 (Ind. 1936).

Taxpayer protests the assessment of tax on purchases of tangible personal property.

II. Tax Administration – Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayer protests the imposition of the ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer, an Indiana S corporation, is a mechanical and fire protection contractor. In addition to installing sprinkler systems into buildings, Taxpayer also provides services regarding plumbing, heating, and air conditioning.

Pursuant to an audit, the Indiana Department of Revenue ("Department") assessed Taxpayer additional sales/use tax on tangible personal property, including, but not limited to, shop supplies, shop tools, safety equipment, and software because Taxpayer did not pay sales tax at the time of the retail transactions nor did Taxpayer self-assess and remit to the Department the use tax due.

Taxpayer protested the assessments. A hearing was held. This Letter of Findings ensues. Additional facts will be provided as necessary.

I. Sales and Use Tax – Exemptions.

DISCUSSION

The Department's audit assessed Taxpayer use tax on its purchases of shop supplies and shop tools because Taxpayer did not pay sales tax nor did it self-assess and remit to the Department the use tax accordingly due. Taxpayer, to the contrary, claimed that it was entitled to the manufacturing exemptions on its purchases of shop supplies and shop tools.

As a threshold issue, all tax assessments are prima facie evidence that the Department's claim for the unpaid tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

Indiana imposes a sales tax on retail transactions and a complementary use tax on tangible personal property that is stored, used, or consumed in the state. IC § 6-2.5-1-1 et seq. Generally, all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly or finishing of tangible personal property are taxable. 45 IAC 2.2-5-8(a). An exemption from use tax is granted for transactions where the gross retail tax ("sales tax") was paid at the time of purchase pursuant to IC § 6-2.5-3-4. There are also additional exemptions from sales tax and use tax. A statute which provides a tax exemption, however, is strictly construed against the taxpayer. Indiana Dep't of State Revenue v. RCA Corp., 310 N.E.2d 96, 97 (Ind. Ct. App. 1974).

IC § 6-2.5-5-3(b) states:

> Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.

IC § 6-2.5-5-5.1(b) provides:

> Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for direct consumption as a material to be consumed in the direct production of other tangible personal property in the person's business of manufacturing, processing, refining, repairing, mining, agriculture, horticulture, floriculture, or arboriculture.

While statutes are silent on what constitutes "manufacture," courts, in several occasions, have attempted to answer this question through statutory construction.

In Hartranft v. Wiegmann, 121 U.S. 609 (1887), the United Stated Supreme Court addressed an importer's claim that it was not a manufacturer and, therefore, was exempt from "a duty of 35 per cent. ad valorem," which

was imposed on manufacturers. The Court opined that:

> The application of labor to an article, either by hand or by mechanism, does not make the article necessarily a manufactured article, within the meaning of that term as used in the tariff laws. Washing and scouring wool does not make the resulting wool a manufacture of wool. Cleaning and ginning cotton does not make the resulting cotton a manufacture of cotton. Id. at 615.

Ruling in favor of the importer, the Court concluded that "cleaning off the outer layer of the shell by acid, and then grinding off the second layer by an emery wheel, so as to expose the brilliant inner layer, [was] not a manufacture of the shell, the object of these manipulations being simply for the purpose of ornament, and some of the shells being afterwards etched by acid, so as to produce inscriptions upon them." Id. at 613-14.

In Anheuser-Busch Brewing Ass'n v. United States, 207 U.S. 556 (1908), a brewer claimed that it was entitled to manufacturing drawbacks for an excise tax it paid on its imported corks, which the brewer used to seal its beer bottles. The brewer maintained that it was a manufacturer of corks because, after the corks were imported from Spain and shipped to its facility, it carefully examined, sorted, cut, washed, bathed, steamed, and dried the corks. The brewer asserted that the process was necessary so it could use the corks to seal its beer bottles. Rejecting the brewer's claim, the Court stated that:

> Manufacture implies a change, but every change is not manufacture, and yet every change in an article is the result of treatment, labor and manipulation. But something more is necessary, as set forth and illustrated in Hartranft v. Wiegmann, [citation omitted]. There must be transformation; a new and different article must emerge, "having a distinctive name, character or use." This cannot be said of the corks in question. A cork put through the claimant's process is still a cork. Id. at 562.

Additionally, in Indiana Creosoting Co. v. McNutt, 5 N.E.2d 310 (Ind. 1936), the Indiana Supreme Court ascertained similar question. Finding the Indiana Creosoting Company was not a manufacturer, the Court elaborated that:

> A manufacturer is defined to be: One who is engaged in the business of working raw materials into wares suitable for use, (or) who gives new shapes, new qualities, new combinations to matter which has already gone through some artificial process. A manufacturer prepares the original substance for use in different forms. He makes to sell, and stands between the original producer and the dealer, or first consumers, depending for his profit on the labor which he bestows on the raw material. Id. at 314. (quoting State v. American Creosote Works, 112 So. 412, 413 (La. 1927)).

In short, to qualify for "manufacture," in addition to a change in an article, there must be "transformation; a new and different article must emerge, having a distinctive name, character or use." Furthermore, a manufacturer "makes to sell, and stands between the original producer and the dealer, or first consumers, depending for his profit on the labor which he bestows on the raw material." Therefore, the manufacturing exemptions are applicable only when a taxpayer (1) engages in the business of producing and manufacturing marketable goods for sale and (2) directly uses or consumes the tangible personal property in direct production.

In this instance, at the administrative hearing, Taxpayer stated that, on some occasions, it fabricated pipes at its facility before it shipped the pipes to jobsites to complete the plumbing installation due to efficiency. Based on specific dimensions which Taxpayer acquired upon entering the plumbing installation contracts, Taxpayer stated that it cut, threaded, assembled, coupled, and glued the required pipes together at its facility prior to shipping them to particular jobsites to complete Taxpayer's installation. Because the pipes were prepared and ready to install, Taxpayer saved time and effort in cutting, threading, assembling, coupling, and gluing the required pipes together on-site as well as cleaning up afterward. Similar to the brewer's arguments in Anheuser-Busch Brewing Ass'n, here, Taxpayer believed that cutting, threading, assembling, coupling, and gluing the pipes together at its facility made Taxpayer a manufacturer of pipes and, therefore, it was entitled to the manufacturing exemptions under Indiana law.

To support its protest, Taxpayer submitted photos and explained how it used shop supplies and shop tools, including, but not limited to, pump repair kit, motor armature, chuck, jaws, springs, transmission, foot pedal switch, pipe dope brush, band saw blade, pipe markers, rags, burlap bags, measuring tape, pipe dies, springs and bolts, grinder, wire brush, marking pens, cutting blades, pliers, brooms, shovel, and switch.

In this instance, based on installation contracts, Taxpayer was engaged in the business of installing pipes, i.e., plumbing. Cutting, threading, assembling, coupling, and gluing pipes together were necessary steps, which Taxpayer had to take to render its service and perform its obligations pursuant to its contracts, which was installing proper plumbing on jobsites. Similar to the corks in Anheuser-Busch Brewing Ass'n, pipes put through Taxpayer's process are still pipes. Taxpayer's documentation did not demonstrate that it acquired "raw materials" to produce marketable goods for sale pursuant to its allegedly manufacturing process. Rather, Taxpayer was selling its professional skills–installing pipes/plumbing. Since Taxpayer is not a manufacturer of pipes, it is not necessary to address the second issue whether Taxpayer directly used the shop supplies and tools in direct production.

45 IAC 2.2-3-12 (c) states:

> Utilities, machinery, tools, forms, supplies, equipment, or any other items used or consumed by the contractor and which do not become a part of the improvement to real estate are not exempt regardless of the exempt

status of the person for whom the contract is performed.

Given the totality of circumstances, in the absence of other documentation, the Department is not able to agree with Taxpayer that it has met its burden to demonstrate that the Department's proposed assessment is wrong. Since sales tax was not paid on Taxpayer's purchases of the shop supplies and shop tools, the use tax was properly imposed.

FINDING

Taxpayer's protest on the purchase of the shop supplies and shop tools is respectfully denied.

II. Tax Administration – Negligence Penalty.

DISCUSSION

Taxpayer also protests the imposition of the negligence penalty.

Pursuant to IC § 6-8.1-10-2.1, the Department may assess a ten (10) percent negligence penalty if the taxpayer:

(1) fails to file a tax return;
(2) fails to pay the full amount of tax shown on the tax return;
(3) fails to remit in a timely manner the tax held in trust for Indiana (e.g., a sales tax); or
(4) fails to pay a tax deficiency determined by the Department to be owed by a taxpayer.

45 IAC 15-11-2(b) further states:

"Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The Department may waive a negligence penalty as provided in 45 IAC 15-11-2(c), in part, as follows:

The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

(1) the nature of the tax involved;
(2) judicial precedents set by Indiana courts;
(3) judicial precedents established in jurisdictions outside Indiana;
(4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;
(5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

Taxpayer failed to provide sufficient documentation establishing that its failure to pay tax or timely remit tax was due to reasonable cause and not due to negligence.

FINDING

Taxpayer's protest on the imposition of the negligence penalty is respectfully denied.

SUMMARY

For the reasons discussed above, Taxpayer's protest on the purchase of the shop supplies and shop tools is respectfully denied. Taxpayer's protest on the imposition of the negligence penalty is also respectfully denied.

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